

MEMORANDUM

To: Tony Perez
Director, City of Seattle

From: Brian T. Grogan
Yuri B. Berndt

Client No. 46687.7

Date: May 21, 2015

Re: Qwest Broadband Services, Inc. – Financial Qualifications

Pursuant to the City's request, we have herein provided information related to the financial qualifications of Qwest Broadband Services, Inc.

I. SCOPE OF REVIEW

Qwest Broadband Services, Inc. d/b/a CenturyLink, ("QBSI"), a Delaware corporation, is an applicant for a competitive cable franchise agreement (hereinafter referred to as the "Franchise Agreement") for the City of Seattle, Washington ("City"). CenturyLink, Inc. ("CenturyLink"), a Louisiana corporation, indirectly wholly owns QBSI. QBSI operates cable television systems that provide cable services throughout the United States. QBSI has requested the City's approval of a competitive cable franchise agreement. At the request of the City, Moss & Barnett, PA has reviewed selected financial information that was provided by QBSI and CenturyLink or publicly available to assess the financial qualifications of QBSI to obtain and operate a competitive cable franchise.

The financial information that was provided or available through other public sources and to which our review has been limited, consists solely of the following financial information (hereinafter referred to collectively as the "Financial Statements"):

1. Application of Qwest Broadband Services, Inc. d/b/a CenturyLink for a Competitive Cable Franchise dated April 27, 2015 , along with such other exhibits as provided therewith (the "Application");
2. Form 10-K for CenturyLink, Inc. filed with the Securities and Exchange Commission on February 24, 2015, for the fiscal year ended December 31, 2014;
3. Form 10-Q for CenturyLink, Inc. filed with the Securities and Exchange Commission on May 6, 2015 for the three-month period ended March 31, 2015;
4. The audited financial statements of CenturyLink, Inc. and subsidiaries as of December 31, 2014 and 2013, including Consolidated Balance Sheets as of December 31, 2014 and 2013, Consolidated Statements of Operations, Comprehensive (Loss)

Income, Cash Flows and Stockholder Equity for the years ended December 31, 2014, 2013 and 2012, and the Independent Auditors' Report of KPMG LLP dated February 24, 2015; and

5. Such other information as we requested and that was provided by QBSI and CenturyLink relating to the Application.

Our procedure is limited to providing a summary of our analysis of the Financial Statements in order to facilitate the City's assessment of the financial capabilities of QBSI to operate a cable system in the City.

II. OVERVIEW OF QWEST BROADBAND SERVICES, INC.

Since 2008, Qwest Broadband Services, Inc., a Delaware corporation, has been providing cable video services and currently provides full video services under the Prism™ platform to 14 markets in the United States,¹ including in the States of Arizona, Colorado, Florida, Nebraska, Nevada, and North Carolina.² QBSI's affiliates provide a broad range of other communication services including broadband, hosting and colocation, VoIP, Ethernet, Internet services, and voice services to residential and commercial customers in various markets in the United States.³ QBSI was formed on May 10, 1999 and is a wholly owned subsidiary of CenturyTel Broadband Services LLC, a Delaware limited liability company, which is wholly owned by CenturyLink, Inc.⁴ As of December 31, 2014, QBSI passed approximately 2.4 million potential customers and served approximately 242,000 cable customers.⁵ CenturyLink employs approximately 2,200 employees in Washington with the majority of those jobs located in the Greater Seattle area.⁶ QBSI's operational management team has practical experience in the cable industry.⁷

Cable providers and telecommunication companies operate in a competitive environment and the financial performance of cable television operators, like QBSI, is subject to many factors, including, but not limited to, the general business conditions, programing costs, incumbent operators, digital broadcast satellite service, technology advancements, changes in consumer behavior, regulatory requirements, advertising costs, and customer preferences, as well as competition from multiple sources, which provide and distribute programming, information, news, entertainment and other telecommunication services.⁸ QBSI has a limited operating history and is dependent upon CenturyLink for all of its funding and the financing of its operations. The cable business is inherently capital intensive, requiring capital for the construction and maintenance of its communications systems. Each of these factors could have a significant financial impact on QBSI and its ability to operate a cable system in the City.

¹ Application at p. 7.

² Application – Exhibit D.

³ Form 10-K for CenturyLink, Inc. filed with the Securities and Exchange Commission on February 24, 2015 for the fiscal year ended December 31, 2014 ("Form 10-K") at p. 6.

⁴ Application – Exhibit B.

⁵ Application at p.7.

⁶ Application at p. 2.

⁷ Application at pp. 2.

⁸ Form 10-K at pp. 17-27.

III. FINDINGS

Based upon the above information, we have analyzed the historical financial statements of QBSI's parent entity, CenturyLink, Inc., in evaluating the financial capabilities of QBSI. QBSI declined to provide us with its stand-alone financial statements or projected financial information for its future operations and the cost to integrate Prism™ into its existing infrastructure in the City. CenturyLink's historical audited financial statements do not separately provide the financial information for QBSI.

As such, we are reporting our Findings hereunder based upon CenturyLink's historical financial information.

1. **Analysis of Financial Statements.** Federal law and FCC regulations provide franchising authorities, such as the City, with limited guidance concerning the evaluation of the financial qualifications of an applicant for a cable franchise. In evaluating the financial capabilities of a cable operator, we believe it is appropriate to consider the performance of an applicant based on the applicant's historical performance and its projected or budgeted financial information along with its financial capabilities (for funding and financing its entire operation). We were not provided with this information for QBSI. As such, we believe a general review of CenturyLink's financial information may provide some insight into the general financial operations of CenturyLink with respect to the Application.

As noted above, CenturyLink's and its subsidiaries' operations include both cable television video services and non-cable television services. According to CenturyLink's Financial Statements, QBSI's customers represent a small portion of CenturyLink's overall customers.⁹ The CenturyLink financial information discussed below includes all of the CenturyLink operations, including the non-cable television video services. We have analyzed CenturyLink's Financial Statements as of March 31, 2015 and as of December 31, 2014 and 2013 in providing the information in this Section.

2. **Specific Financial Statement Data and Analysis.**

(a) **Assets.** CenturyLink had (i) current assets of \$3,468 million, \$3,576 million, and \$3,907 million; (ii) working capital of a negative \$111 million, a negative \$342 million, and a negative \$502 million; and (iii) total assets of \$49,520 million, \$50,147 million, and \$51,787 million as of March 31, 2015 and December 31, 2014 and 2013, respectively.¹⁰ Working capital, which is the excess of current assets over current liabilities, is a short-term analytical tool used to assess the ability of a particular entity to meet its current financial obligations in the ordinary course of business. The working capital trend shows a slight decrease in the negative working capital from December 31, 2013 to March 31, 2015, which suggests that CenturyLink's cash flow, may be getting stronger. CenturyLink's current ratio (current assets divided by current liabilities) as of March 31, 2015, of 0.97/1.0 is near the generally recognized standard of 1:1 for a sustainable business operation.¹¹ As of March 31, 2015,

⁹ Form 10-Q for CenturyLink, Inc. filed with the Securities and Exchange Commission on May 6, 2015 for the three month period ending March 31, 2015 ("Form 10-Q") at p. 21 and Application at p. 1.

¹⁰ Form 10-K at p. 69 and Form 10-Q at p. 5.

¹¹ Form 10-Q at p.5.

CenturyLink had \$155 million of cash on its balance sheet.¹² Approximately one-third of its cash is held off shore and is subject to restrictions on usage.¹³ As noted above, QBSI did not provide us with any budget of cash flow or cost with respect to its expansion of the Prism™ service or any of its other potential cash capital needs. As such, it is difficult to predict what amount of free cash on hand is needed to bring the Prism™ system online in the City (and other cities in which QBSI is rolling out its video service). We also note that approximately fifty-five percent (55%) of CenturyLink's assets are comprised of its intangible Goodwill.¹⁴

(b) **Liabilities.** CenturyLink's Financial Statements report (i) current liabilities of \$3,579 million, \$3,918 million and \$4,409 million; (ii) long-term debt of \$20,254 million, \$20,121 million and \$20,181 million; and (iii) deferred obligations of \$10,922 million, \$11,085 million and \$10,006 million as of March 31, 2015 and December 31, 2014 and 2013, respectively.¹⁵ According to CenturyLink, it has \$1.7 billion available on its \$2 billion revolving credit facility as of March 31, 2015 (which matures on December 31, 2019).¹⁶ CenturyLink's credit facilities include affirmative and negative covenants that if violated, could result in a cascade of defaults under its debt obligations and immediate cash and/or financing needs.¹⁷ According to the Financial Statements, CenturyLink is not in default of these requirements at the current time.¹⁸ CenturyLink has in excess of \$2.5 billion of debt maturing in the next 3 years which if not paid or refinanced could have a significant impact on the financial viability of CenturyLink.¹⁹ Any additional debt, including by drawing on its available revolving credit facility, will require CenturyLink to generate additional cash flow, including through its operations, to fund its debt service.

(c) **Income and Expense.** CenturyLink's Statements of Operations report (i) revenue of \$4,451 million, \$18,031 million and \$18,095 million; (ii) operating expenses of \$3,802 million, \$15,621 million and \$16,642 million; and (iii) net income (loss) of \$192 million, \$772 million and (\$239) million for the three-month period ending March 31, 2015 and the years ending December 31, 2014 and 2013, respectively.²⁰ CenturyLink is reporting net income in 2015 and 2014.²¹ The ability to generate cash is important for CenturyLink due to its leveraged operations. With the expansion of Prism™, CenturyLink may be required to incur significant expenditures for the assimilation of its video services into its existing platform along with additional programming costs to obtain and maintain its programming in the future. Over the last 3 years, CenturyLink has been able to generate cash flow from operations to cover its investing and financing activities.²²

¹² Form 10-Q at p. 30.

¹³ Form 10-Q at p. 30.

¹⁴ *Id.*

¹⁵ Form 10-K at p. 69 and Form 10-Q at p. 5.

¹⁶ Form 10-Q at pp. 30 and 32.

¹⁷ Form 10-Q at p. 32.

¹⁸ *Id.*

¹⁹ Form 10-K at p. 82.

²⁰ Form 10-K at p. 68 and Form 10-Q at p. 4.

²¹ *Id.*

²² Form 10-K at p. 70 and Form 10-Q at p. 6.

IV. SUMMARY

We are not aware of any state or federal standards by which to assess the financial qualifications of a competitive cable operator seeking an initial franchise in the City. The FCC has provided a minimal standard to consider when assessing the qualifications of a prospective transferee when a cable system is sold or control of the franchise changes. This FCC financial qualification standard is found in FCC Form 394. Using the FCC Form 394 to establish an absolute minimum standard of financial qualifications that a proposed applicant must demonstrate in order to be qualified to obtain and operate a cable system, QBSI has the burden of demonstrating to the City's satisfaction that QBSI has "sufficient net liquid assets on hand or available from committed resources" to obtain and operate the system in the City, together with its existing operations, for three (3) months. This minimum standard is not easy to apply to a company that is in aggressive growth mode and expanding its operations.

Based solely on CenturyLink's (QBSI's indirect parent entity) financial information that we reviewed, CenturyLink appears to have sufficient funding to finance, operate and bring its cable system online in the City. Based on the foregoing and limited strictly to the financial information analyzed in conducting this review, we do not believe that QBSI's request for application for a Competitive Cable Franchise in the City can reasonably be denied based solely on a lack of financial qualifications of QBSI and CenturyLink. Due to the many uncertainties and lack of information regarding the proposed funding and future operations, there is not enough information that has been made available to make any conclusions regarding the financial qualifications of QBSI. The determination as stated above is based solely upon the CenturyLink Financial Statements.

In the event the City elects to proceed with approving the issuance of a competitive cable franchise, the assessment of QBSI's, and its parent entity CenturyLink's, financial qualifications should not be construed in any way to constitute an opinion as to the financial capability or stability of QBSI or CenturyLink to (i) operate under a competitive Franchise Agreement, and (ii) operate its other operations. The sufficiency of the procedures used in making an assessment of QBSI's and CenturyLink's financial qualifications and its capability to operate a competitive system in the City is solely the responsibility of the City. Consequently, we make no representation regarding the sufficiency of the procedures used either for the purpose for which this analysis of financial capabilities and qualifications was requested or for any other purpose.

Lastly, in order to ensure compliance with its obligations to operate the cable system in the City and since we have based all of our analysis on CenturyLink's Financial Statements, the parent entity, the City may seek to require a corporate parent guaranty as part of issuing a competitive Franchise Agreement to QBSI in a form as set forth in Exhibit A or as otherwise mutually agreeable to QBSI and the City. In the alternative to a corporate parent guaranty, the City may seek to require adequate financial security by imposing a construction bond/performance bond and security fund obligation to ensure that QBSI has access to financial resources necessary to meet the requirements of any franchise granted.

EXHIBIT A

CORPORATE PARENT GUARANTY

THIS AGREEMENT is made this _____ day of _____, 201__ (this "Agreement"), by and among CenturyLink, Inc., a Louisiana corporation (the "Guarantor"), the City of Seattle, Washington ("Franchising Authority"), and Qwest Broadband Services, Inc., a Delaware corporation ("Company").

WITNESSETH

WHEREAS, on _____, 20__ the Franchising Authority adopted Ordinance No. _____ granting a Competitive Cable Television Franchise to the Company (the "Franchise"), pursuant to which the Franchising Authority has granted the rights to own, operate, and maintain a competitive cable television system in the City ("System"); and

WHEREAS, pursuant to Resolution No. _____, dated _____, 20____, Franchising Authority conditioned its consent to the issuance of a Competitive Cable Franchise Agreement on the issuance by Guarantor of a corporate parent guaranty guaranteeing certain obligations of the Company under the Franchise; and

WHEREAS, the Company is indirectly wholly owned by Guarantor, as the parent entity of a consolidated group which includes the Company.

NOW, THEREFORE, in consideration of the foregoing premises and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, in consideration of the approval of the issuance of a Competitive Cable Franchise Agreement, Guarantor hereby unconditionally and irrevocably agrees to provide all the financial resources necessary for the observance, fulfillment and performance of the obligations of the Company under the Franchise and also to be legally liable for performance of said obligations in case of default by or revocation or termination for default of the Franchise.

This Agreement, unless terminated, substituted, or canceled, as provided herein, shall remain in full force and effect for the duration of the term of the Franchise.

Upon substitution of another Guarantor reasonably satisfactory to the Franchising Authority, this Agreement may be terminated, substituted, or canceled upon thirty (30) days prior written

notice from Guarantor to the Franchising Authority and the Company. Such termination shall not affect liability incurred or accrued under this Agreement prior to the effective date of such termination or cancellation.

GUARANTOR:

CenturyLink, Inc.

By: _____

Its: _____

STATE OF _____)
COUNTY OF _____) ss.

The foregoing instrument was subscribed and sworn to before me this ____ day of _____
____ 20____, by _____, the _____
____ of _____.

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